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## Throw out the tax code

There's plenty of revenue to be had if California fixes its outdated, unfair system.

By Mark Paul  
April 20, 2008

Politicians don't like to talk about taxes except to brag about cutting them. But with California's widening budget deficit threatening deep cuts in education and other public services, it's difficult to avoid discussions about raising taxes.

Unfortunately, what's likely to be lost in the upcoming partisan melee over whether new taxes are needed to close the \$16-billion gap is an equally important tax issue - California's aging and often unfair tax system needs to be overhauled.

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The goal of tax reform should be twofold. One is to generate a more reliable revenue stream. The other is to make the tax code more reflective of California's changing economy, which in turn could stimulate more growth.

Gov. Arnold Schwarzenegger has tentatively embraced the idea of tax reform. "If it is property tax, if it is personal income tax, if it is sales tax ... if it is services, Internet," he said last week at a town hall meeting, "one has to look at all of those things together and say, let's bring it up to date, the system."

The major elements of the state's tax system were set in place during the Depression. The modern corporation and bank tax was enacted in 1929, the sales tax in 1933, the income tax (with a top rate of 15%) in 1935 and the statewide uniform vehicle license fee

(the "car tax") in 1937. The big industries of that California -- agriculture, motion pictures, tourism -- relied on sunshine and produced mostly tangible goods, a lot of them sent to market in cans: peaches, sardines and movies.

The industries that drive today's state economy -- software, information services such as Google, high-tech, diversified manufacturing, movies, video games, professional and business services -- run on entrepreneurship, knowledge, creativity and technology. They produce more services and intangibles than hard goods. Operating in a global market, they face new competition from anywhere. And they can locate wherever there are fast broadband communications, good transportation, skilled workers and a high quality of life to attract and hold employees.

The state's tax system simply hasn't kept up with this transformation of its economy.

Although the overall state and local tax burden on California businesses is almost the national average -- and lower than in Florida and Texas, according to the Council on State Taxation, a nonprofit trade association -- the system, in general, treats new investment and new firms unfavorably. That doesn't promote economic growth.

How broken is the system? California is one of only four states that imposes sales taxes on manufacturing equipment. Because of Proposition 13, the property taxes of start-up companies that construct or buy their business facilities are assessed at current market value. That puts them at a disadvantage vis-a-vis longer-established competitors, whose property taxes are based on lower assessments from decades ago, regardless of the current value of the property in producing income for the firms. In a fiercely competitive global economy, none of this is very smart or

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strategic.

The sales tax paid by consumers is also out of step with changing economic reality. Today, consumers spend an increasing share of their income on such services as healthcare, gyms and gardeners as opposed to such tangible goods as clothes and furniture. But California, unlike most other states, still levies the sales tax on a relatively narrow range of tangible goods while exempting food, utilities and medicine. As a result, the dollars Californians spend yield about 30% less sales tax than they did in 1979. Even though California has among the highest sales tax rates in the country -- the combined state and local rate ranges from 7.25% to 8.75% -- the fact that it isn't levied on such things as amusements, repair services, car washing and limos causes revenues to lag behind the state's growth and the need for public services.

As a revenue raiser, California's income tax is a Swiss cheese. It incorporates most of the exclusions, exemptions and deductions in the federal tax code, including such biggies as the mortgage-interest deduction and the exclusion of employer-paid health insurance premiums. Then it adds more than two dozen holes of its own. Among them are a total exemption for Social Security benefits, which costs the state \$1.8 billion a year; a credit for using rice straw in any other way than burning it; a credit for transporting donated farm products; and an exemption for state lottery winnings.

A smart tax system does its work of raising needed revenues while attempting to minimize economic harm and advancing certain social goals. California's system doesn't meet that standard. It taxes desirable activities -- work, through the income tax, saving and investment -- but not some undesirable ones, like pollution and the emission of carbon dioxide and other gases that contribute to global warming. And in defiance of all good economic sense, California has held down fuel taxes, which are a user fee, thereby shifting much of the burden of transportation funding toward the sales tax and bonds paid for with general taxes, and breaking the feedback loop between driving and paying for roads.

Such a system creates economic distortions and unfairness. You pay sales tax, meant to be a broad levy on personal consumption, when you buy a music CD but not on the same songs if you buy and download them online. If you wash your own clothes, you pay sales tax on your washer and laundry soap. If you can afford to send your laundry out, you pay no tax.

There's no good rationale for favoring iTunes customers over people who buy CDs at Wal-Mart, or the laundry customer over the home laundry. Playing favorites on different forms of consumption makes the economy less efficient. California's economy would be stronger if the sales and income taxes had a broader base but lower rates.

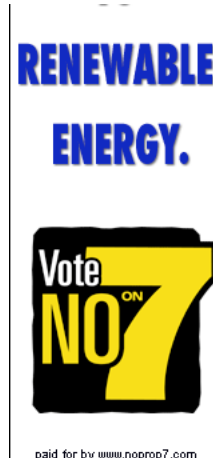
Some hard-line conservatives argue, as the headline of a recent Op-Ed article put it, that "no tax loopholes merit closing." That leaves the rest of us to wonder how Democrats, who have controlled the Legislature for most of the last 50 years, managed to get everything right about taxes except their overall level. Conservatives fear tax reform is only a cover for tax-raising. But even if the state doesn't choose to raise a dime more in revenue, there's potentially an enormous benefit in making the tax system better match California's fast-changing economy.

A smart and strategic tax-reform package would contain a mix of changes -- tax cuts and tax increases -- aimed at removing penalties on new investment and unfair treatment of different activities.

It might remove the sales tax on manufacturing and research equipment, exempt most businesses from paying property tax on tangible personal property -- computers, tables and stoves -- and reassess nonresidential commercial property at market rates. It might cut the overall sales tax rate while broadening its application to such consumer services as cable television, movie and sports admissions, golf courses, amusement parks and personal rentals (parking and mini-storage). And don't forget the purchase of digital equivalents of tangible goods -- e-books and music and movie downloads. A new tax code might begin imposing a carbon tax, helping California meet its global warming goals, and use the proceeds to lower the sales and income tax rate, helping the overall economy.

Unthinkable? No more unthinkable than a Democratic Congress and a Republican President Reagan agreeing on the landmark 1986 tax reform, which lowered tax rates while broadening the base. Reforming California's tax system will take more time than a budget cycle. But until the effort is undertaken, the state will continue to suffer from an unreliable revenue stream, and an economy whose rate of growth is hamstrung by an outdated tax system.

Mark Paul, senior scholar at the New America Foundation, was formerly deputy treasurer of California and deputy editorial page editor of the Sacramento Bee.



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